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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Chairman, Committee On Post Office And Civil Service House Of Representatives

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Analysis Of Grace Commission Proposals To Change The Civil Service Retirement System

The Commission recommended many changes to the civil service retirement system which it said would reduce costs and make the federal system comparable to private sector retirement programs. GAO agrees that private sector practices are one standard that can be used in evaluating the federal program and that, in many respects, the Commission's recommendations reflect pension plan features commonly found in the private sector.

However, the Commission's proposals did not include a capital accumulation plan which is a major element of private sector retirement programs. Without such a plan, adoption of the Commission's recommendations would result in federal employees receiving lower benefits than are typically available to private sector employees. Moreover, for many of the recommendations, the Commission overstated the level of savings that could be achieved.

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WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-217614

The Honorable William D. Ford
Chairman, Committee on Post Office
and Civil Service
House of Representatives

Dear Mr. Chairman:

This is in response to your letter of November 20, 1984, asking for our analysis of the recommendations made by the President's Private Sector Survey on Cost Control, commonly referred to as the Grace Commission, to change the civil service retirement system.

On the basis of its study, the Commission concluded that the cost and benefit levels of the civil service retirement system are much greater than private sector retirement programs. Generally, its recommendations were presented as a means by which the federal retirement system could be made comparable to private sector pension plans.

The Commission estimated savings of $43 billion on a present value basis, if all of its recommendations were implemented. It separately calculated present value savings of $30 billion if the cost of civil service retirement were reduced to the Commission's estimate of private sector costs, recognizing there may be some overlap and duplication in the $43 billion estimate.

We analyzed the Commission's recommendations by comparing them to our prior study of private sector retirement programs. In a June 26, 1984 report entitled Features of Nonfederal Retirement Programs (GAO/OCG-84-2), we showed the prevailing features of nonfederal retirement programs contained in selected studies and/or data bases. We used information from Office of Personnel Management reports on the cost of the civil service system and statistical data on civil service retirees to analyze the Commission's savings estimates.

We agree with the Commission that certain features of the civil service retirement system are superior to those in

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retirement programs typically available in the private sector. Long-term employees (those with 30 or more years of service) can retire without a benefit reduction at age 55. In most private sector pension plans, benefits are reduced when employees retire before age 62. Similarly, civil service benefits are adjusted for increases in the cost of living, whereas full inflation protection is generally not available to private sector retirees.

The civil service retirement system has historically been the only source of retirement income earned by covered employees during their government employment. Federal employees hired after December 31, 1983, are covered by social security. However, as shown in our report on features of nonfederal retirement programs, a private sector retirement program generally consists of three parts--social security, a pension plan, and a capital accumulation plan (employee stock-ownership plan, profit-sharing plan, thrift plan, deferred compensation plan, etc.)

In our opinion, private sector retirement practices are one standard that can be used in evaluating the federal retirement system. We found the Commissions recommendations, in many respects, to be representative of private sector plan features. However, the Commission's proposals did not include a capital accumulation plan which is a major element of private sector retirement programs. Without such a plan, adoption of the Commission's recommendations would result in federal employees receiving lower benefits than are typically available to private sector employees. It also should be noted that when considering changes in any one element of compensation, such as retirement, the other elements should be kept in mind so that the effect on total compensation can be assessed.

Our analysis showed that, for many of the recommendations, the Commission overstated the level of savings that could be achieved.

Some of the Commission's recommendations would reduce the value of accrued benefits employees have already earned. If such changes were attempted in the private sector, they could violate the prohibition against reductions in accrued benefits in private sector plans contained in the Employee Retirement Income Security Act of 1974. Moreover, two of the recommendations would reduce benefit amounts now being paid to many retirees. If enacted, these benefit reductions could be questioned in the courts.

Our analysis of the issues raised and recommendations proposed by the Commission under each issue is contained in the appendix.

B-217614

As you requested, we are sending a copy of this report to the Chairwoman, Subcommittee on Compensation and Employee Benefits. Also, as arranged with your office, we are sending a copy of the report to the Chairman, Senate Committee on Governmental Affairs. Unless you publicly announce its contents earlier, we plan as arranged no further distribution of the report for 7 days after the date of issuance.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

ANALYSIS OF CIVIL SERVICE RETIREMENT ISSUES RAISED AND RECOMMENDATIONS PROPOSED BY THE GRACE COMMISSION

RETIREMENT AGE ISSUE

The Commission recommended that age 62 be established as the earliest age at which civil service employees could retire with full benefits and that benefit amounts for retirees younger than age 62 be subject to an actuarial reduction.[1] The Commission proposed that this recommendation apply to all new employees as well as current employees under age 45.

Civil service employees can now opt to retire with full benefits at age 55 if they have 30 years of service. Employees with shorter periods of service must work past age 55 before they can retire (age 60 after 20 years of service and age 62 after 5 years of service). Because of the 30-year service requirement, most federal employees do not qualify for retirement at age 55. Moreover, many employees do not retire immediately upon reaching retirement eligibility. These factors are reflected in the following statistics on 1983 retirees.[2]

Age group	Percentage of retirees	Average age	Average years of service
55 to 59	34	56.3	34.4
60 to 61	19	60.4	28.8
62 and over	47	64.5	24.3
All retirees	100	60.9	28.6

[1]The term actuarial reduction refers to the amount by which an annual annuity must be reduced if payment of the annuity begins at an earlier age than the normal retirement age specified by the pension plan. The purpose of the reduction is to make the estimated total future payments, when started at the earlier age, equal to the estimate of what the payments would be if started at the specified age. In effect, the reduction neutralizes the age differential, recognizing the probable longer period retirement payments will be made when begun at an earlier age.

[2]These statistics cover 61,605 employees who elected to retire in 1983 under the retirement system's optional retirement provisions. They do not include the 19,122 individuals who retired under disability or involuntary retirement provisions or under the special provisions for certain employee groups such as law enforcement and firefighter personnel.

Our analysis of private sector retirement plan features confirms the Commission's position that age 62 is a commonly used "normal" retirement age (earliest age when full benefits are available). However, some plans allow long-service employees (those who work 30 years or more) to retire with full retirement benefits at earlier ages. For example, a survey[3] conducted by the Bureau of Labor Statistics of retirement plans covering about 17 million private sector employees showed that 13 percent of the employees were in plans that allowed retirement at any age if the employees had 30 years of service. Thus, adoption of the Commission's recommendation would remove the distinction that the civil service retirement system and some private sector plans make between long- and short-service employees.

Our analysis indicates that when employees retire before age 62, benefit amounts in private sector plans are usually reduced, but these reductions are generally less than actuarial.

We recognize that providing full benefits at age 55 along with full inflation protection is a more liberal benefit than found in typical private sector plans and may warrant some adjustment. However, the Commission's omission of a capital accumulation plan as part of its proposed federal retirement program is a significant shortcoming when considering the issue of pension plan benefit reductions for retirements before age 62. For example, thrift plans, the most common type of capital accumulation plan in the private sector, typically provide that employers will match 50 percent of employee contributions up to 6 percent of pay. Participating employees may have enough assets accumulated in the thrift plan to provide a reasonable level of retirement income in conjunction with their reduced pension plan benefits to make early retirement an option. By not including such a plan, the Commission's recommendation could effectively preclude a similar option for federal employees.

We are also concerned about the proposed application of the change to current employees under age 45. This would be a retraction of a promised benefit to employees who have worked many years under the current provisions. If such changes were attempted in the private sector, they could violate the statutory prohibition against reductions in accrued benefits in private sector plans contained in the Employee Retirement Income Security Act of 1974, as amended.

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[3] Employee Benefits in Medium and Large Firms, 1982 (Bureau of Labor Statistics Bulletin 2176, August 1983).

On the basis of the Office of Personnel Management's (OPM's) determination that the proposed changes would reduce the retirement system's cost by 2.2 percent of payroll, the Commission estimated that adoption of its recommendation would save $3.7 billion in a 3-year period after full implementation. The savings estimate is 2.2 percent of projected payroll in the years 2001-03 discounted to the present at 6 percent a year. There would be no reduction in outlays for at least 11 years, when some current 44-year-old employees would otherwise be eligible to retire. If the changes were to apply only to new employees, it would take much longer for outlay reductions to result.

In estimating the system's cost, OPM must make various predictions about future economic events. The cost estimate assumes that (1) the rate of inflation will average 5 percent a year; (2) federal employees will receive pay raises of 5.5 percent a year; and (3) the civil service retirement fund will earn 6 percent a year on its investments. The validity of the estimate depends on the appropriateness of these assumptions. We are particularly concerned with the interest rate assumption. The retirement fund is currently earning an average rate of return of more than 10 percent on its investments and will continue to receive this rate on its current holdings. A relatively small increase in the interest rate assumption would cause a significant decrease in the cost estimate. For example, increasing the interest rate assumption from 6 to 7 percent will reduce the cost estimate by 25 percent. To the extent that the system's cost estimate is overstated, the Commission's savings estimate is also overstated.

EARLY RETIREMENT ISSUE

Early civil service retirements can be allowed during agency reorganizations and work force reductions. Eligible employees can retire if they are 50 years old and have 20 years of service or at any age if they have 25 years of service. Benefit amounts for the early retirees are reduced by 1/6 of 1 percent for each month (2 percent a year) that they are under age 55.

The Commission made two recommendations to reduce early retirement costs. It recommended that early retirements be permitted only when employees are dismissed as a result of a reduction in force and that actuarial reductions be applied to the benefit amounts so the system would incur no additional costs from the early retirements.

In making the first recommendation, the Commission cited our report on tightening eligibility standards for involuntary retirement (GAO/FPCD-81-71, Sept. 25, 1981) that made virtually the same recommendation. However, legislation to implement our

recommendation has already been enacted by the Congress (the Omnibus Budget Reconciliation Act of 1982). Thus, this recommendation is moot.

The effect of the second recommendation would be to require an early retirement reduction at least three times greater than the reduction that is now applied. Currently, early retirements in the civil service system are allowed only when employees are generally being separated through no fault of their own and cannot continue their careers. We have not analyzed private sector practices in similar circumstances, but we have noted that some private employers give added retirement benefits to encourage employees to retire early when the work force is being reduced. The Commission did not discuss private sector practices in this area.

The Commission estimated that adoption of these recommendations would save $1.2 billion in the first year of implementation and $3.7 billion in the first 3 years, on a present value basis.

There are no further savings to be realized from the first recommendation since the proposed change is already law. (The Commission had attributed $117 million of the 3-year savings of $3.7 billion to this recommendation.)

The estimated 3-year savings of $3.6 billion for the second recommendation are too high. Relatively few employees retire early from the government (4.4 percent of retirees in 1981, 6.2 percent of retirees in 1982, and 4.2 percent of retirees in 1983). The number is decreasing because the Congress enacted legislative changes we recommended to tighten the eligibility criteria. With this small number of employees involved, it would be unrealistic to expect to save $3.6 billion in any 3-year period solely by increasing the early retirement reduction over its current level. The annual annuities for 1983 early retirees totaled less than $50 million.

LONG-TERM DISABILITY ISSUE

The Commission recommended that disability retirement be removed from the civil service retirement system and established as a separate long-term disability program structured along the lines of private sector long-term disability plans. It also recommended that the definition of disability used by the civil service system be changed to be consistent with social security and private sector plans; that is, inability to perform any substantive gainful employment.

The Commission estimated that adoption of these recommendations would save $501 million over 3 years, on a present value basis.

Our analysis of private sector retirement programs indicates that employees may receive disability benefits from a pension plan, a long-term disability insurance plan, or both, in addition to disability benefits from social security. As described in our earlier report on features of nonfederal programs, studies showed that the separate insurance plan approach is most often used by employers with compensation-based pension plans for their employees. (The civil service retirement system is a compensation-based pension plan. Such plans consider salary levels in determining benefit amounts.) The private sector insurance plans typically provide 60 percent or more of pay to disabled workers, less any social security or other disability benefits received. Disability insurance benefits are paid as long as the disability continues or until such time as the individual reaches a specific age (usually age 65). At that time, retirement benefits are paid, and insurance benefits are terminated.

The Commission recommended that the government use the separate insurance plan approach. We agree that this would be consistent with private sector practices. However, the Commission did not recommend that the insurance plan provide the same level of benefits as provided by private sector plans but intended that the plan provide the same level of benefits that the civil service system now provides. As currently structured, civil service disability benefits are generally less than the 60 percent of pay provided in private sector insurance plans. If the private sector approach to providing disability benefits is adopted, we believe private sector benefit levels should also be adopted.

We agree with the Commission's assertion that the civil service disability criterion is more liberal than the criterion used in social security and the private sector. However, the criterion for civil service disability retirement has been tightened considerably in recent years, primarily at our suggestion.[4] Employees must now be unable to perform their jobs, or any other job at the same grade level for which they are qualified, before disability retirement will be approved. The

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[4]Disability Provisions of Federal and District of Columbia Employee Retirement System Need Reform, FPCD-78, July 10, 1978.

number of employees retiring on disability has dropped dramatically since this criterion was adopted. The Commission acknowledged the recent reduction in disability retirement approvals and estimated that disability retirement costs had been cut in half as a result. We are not in a position at this time to determine whether the eligibility criteria should be further tightened.

The Commission based its savings estimate on the perceived difference in cost between private sector disability plans and civil service disability retirement. (The Commission estimated civil service disability costs at 2.5 percent of payroll and private sector disability costs at 2.2 percent of payroll.) It then assumed that, if private sector practices were adopted, a savings equivalent to .3 percent of payroll, or $501 million on a present value basis over a 3-year period, could be achieved.

The Commission's report did not explain how the 2.2 percent private sector cost estimate was derived. Therefore, we could not tell if the estimate was limited to the cost of employer programs only or included the cost of social security disability benefits. If social security costs were not included, the estimate is understated. Also, the cost difference could be caused by the different structures of the programs in the two sectors. Private sector disability insurance benefits terminate when employees reach age 65, whereas civil service disability retirement benefits can be paid for life. In any event, with the exception of possibly fewer retirements by tightening the eligibility criterion, there would be no savings from the recommendations if the new program provided the same level of disability benefits as the civil service retirement system now provides. If the higher private sector benefit levels were established for federal employees, adoption of the recommendations could prove more costly than civil service disability retirement, particularly for those employees hired before January 1, 1984, who do not have social security coverage.

BENEFIT FORMULA ISSUE

The Commission said that revision of the civil service benefit formula to bring annuities more in line with private sector practices would save an estimated $25 billion on a present value basis, over 3 years, following full implementation.

The Commission made six recommendations to reduce civil service benefit amounts. These were as follows.

--Adopt a benefit accrual rate of 1.5 percent of average salary less a social security offset of 1.25 percent for each year of service. The new formula and social security coverage would apply to new employees and all current employees under age 45.

--Change the salary base used in benefit calculations from the current 3-year average to a 5-year average.

--Eliminate the practice of crediting unused sick leave toward years of service in computing benefits.

--Base survivor benefit reductions on actuarial factors rather than the fixed reduction percentages that are now applied.

--Eliminate survivor benefits for young adults between ages 19 and 22 who are full-time students in post-secondary schools.

--Increase the service requirement for vesting (point when participant has earned the right to accrued benefits) from the current 5 years to 10 years.

In our opinion, some of these recommendations would have merit if they applied only to federal employees hired after December 31, 1983, who have social security coverage. For example, the proposed benefit formula appears to be generally comparable with formulas in private sector pension plans. Similarly, the proposed 10-year vesting requirement is consistent with private sector practices and could be appropriate for new federal employees whose social security coverage provides protection for shorter periods of service. Also, using the 5-year salary average and basing survivor benefit reductions on actuarial factors would be consistent with private sector practices. Whether federal employees under age 45 hired before January 1984 should be covered by these provisions (and social security), as the Commission proposed, is a policy issue which the Congress must decide. The Congress decided in the 1983 Social Security Amendments to limit social security coverage to newly hired federal employees.

The recommendation to eliminate survivor benefits for post-secondary students has merit. These benefits were added to the civil service system in 1962 to be consistent with a similar provision in the social security program. The social security provision has been eliminated, effective April 1985. Elimination of the civil service provision would be consistent with this action.

The reasonableness of the sick leave credit recommendation is questionable. The sick leave credit was added to the retirement system in 1969 as an incentive for employees to use their sick leave judiciously. While the proposed change follows private sector practices, the potential impact on sick leave usage must be considered.

The recommended change in the civil service benefit accrual rate accounted for $18.4 billion of the $25 billion savings estimated by the Commission for this issue. We question these savings. Since the Commission acknowledged that private sector and civil service benefit levels at retirement are comparable, there would be no apparent savings from incorporating into the civil service system the typical private sector benefit formula which provides the same level of benefits. Furthermore, the estimate was based on reductions in the cost of the current civil service system that would result and did not consider the added cost of social security.

We have no reason to question the estimated savings in retirement costs from the other recommendations if the underlying assumptions used are appropriate. As previously discussed (see the retirement age issue), the savings estimates are based on certain economic assumptions that may or may not be valid.

COST-OF-LIVING ADJUSTMENTS ISSUE

As a general rule, civil service annuities are fully indexed to increases in the Consumer Price Index (CPI). The Commission concluded that federal retiree adjustments were more liberal than those granted to private sector retirees. It acknowledged that social security benefits are also fully indexed but maintained that, on average, private sector pension plan adjustments offset only about 33 percent of the annual increase in the CPI.

To make the civil service system comparable with private sector programs, the Commission recommended that current civil service retirees and current employees over age 45 receive full adjustments only on the amount of their annuities equivalent to the social security benefits they would have received if their federal employment had been covered by social security. Any annuity amount in excess of the social security equivalent would be indexed at 33 percent of the CPI increase. Similarly, for new employees and current employees under age 45, who the Commission recommended be covered by social security, annuity adjustments would be limited to 33 percent of the CPI increase. The Commission estimated that these changes would save $7.3 billion over 3 years, on a present value basis.

We generally agree that civil service cost-of-living adjustments are higher compared with the adjustments private sector retirees receive from social security and employer pension plans. However, we are concerned that the Commission's proposals may go too far. Our analysis indicates that private sector pension plan indexing, particularly for the largest plans, is greater than the 33 percent the Commission recommended for the civil service

system. A study[5] conducted for the Department of Labor showed that, during 1973 to 1979, private sector pension plans increased benefits on the average by 38 percent of the CPI, not including social security benefit adjustments. In plans with 10,000 or more recipients, the average increase during the period was 57 percent of the CPI increase.

Reducing the inflation protection in the civil service system to 33 percent on all amounts above the social security level would cut costs substantially. We have no reason to question the estimated savings associated with this issue if, as previously discussed, the Commission's savings estimates for its recommendations are based on valid economic assumptions.

FEDERAL PENSION INTEGRATION ISSUE

The Commission said the objectives of its recommendations under this issue were to recognize the federal government as a single employer and to eliminate windfall benefits employees could receive from overlapping and duplicative benefits in the civil service, military, and social security retirement programs.

To accomplish these objectives, the Commission recommended that a social security offset be applied to retiring and retired federal employees regardless of retirement date. The offset to civil service annuities would be 1.25 percent of any social security benefits received multiplied by each year of federal service. Another recommendation would eliminate credit for military service in the civil service system, including reductions in current retirees' annuities for any military service credits they had been granted. The Commission estimated these recommendations would save $2.6 billion over 3 years.

We cannot agree with the Commission that the civil service, military, and social security retirement programs provide overlapping and duplicative benefits to federal employees. Employees in the civil service system hired before January 1984 were not covered by social security; therefore, they earned no social security benefits from their federal civilian employment. It is true that many of these employees do obtain social security coverage from employment outside the government in other jobs. However, these social security benefits do not overlap or duplicate any civil service benefits the employees receive. Undoubtedly, many private sector employees also earn retirement benefits from more than one employer.

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[5]Inflation and Pension Benefits, Department of Economics and Business, North Carolina State University, August 1983.

Moreover, the social security law was changed in 1983 to remove the so-called "windfall" benefits that some federal retirees received from working a relatively short time in social security covered employment outside the government. Under this law, social security benefits for retirees who also receive a civil service annuity will be calculated under a less generous formula than the formula used for other workers.

Similarly, military service (other than active duty periods for reservists) is not creditable under both the military and civil service retirement systems. It is entirely possible for a person to receive retirement benefits from the two systems, but the benefits would have been earned during different periods of federal service.

Military service after 1956 was covered by social security. Until legislation was enacted in 1982, federal civilian employees who had military service after 1956 could not use this service period under the civil service retirement system if they became eligible for social security benefits. The legislation allows such military service to be used for both civil service and social security benefits if the employees contribute 7 percent of their military pay to the civil service fund. Employees hired after the legislation was enacted must make the contribution in order for their military service to be creditable under the civil service system, regardless of whether they become eligible for social security benefits.

If enacted, the Commission's recommendations would cause a significant cut in many current retirees' benefits. Such retroactive benefit reductions could be questioned in the courts.

The Commission estimated that the social security offset recommendation would reduce civil service benefits for each retiree over age 65 by an average of $1,890 a year. The reduction would be phased in over 4 years. In making this estimate, the Commission assumed that all civil service retirees over age 65 were receiving social security benefits and that these benefits were equal to the average benefit received by all social security recipients over age 65. It also assumed that each of the retirees had 30 years of federal service. These assumptions appear to be too high when compared to a study by the Social Security Administration entitled Civil Service Retirement System Annuitants and Social Security. The study showed that in 1979, about two-thirds of all civil service retirees over age 62 were entitled to social security benefits from other employment. However, their civil service benefits and their social security benefits were less than the average benefits paid under each program.

In calculating the savings from eliminating military service credits, the Commission estimated that 48 percent of all male retirees had an average of 4.6 years of military service each. We have insufficient data to determine the validity of these estimates. OPM data indicates that the average military service credit for all retirees on the retirement roll at the end of fiscal year 1983 was 1.8 years.

GOVERNMENT PENSION ACCOUNTING PRACTICES ISSUE

The Commission concluded that the cost and liabilities of the civil service retirement system are much greater than recognized by current costing and funding procedures. It called for full funding of accruing retirement costs in agency budgets and for amortization (the systematic payment over a specified period) of the retirement system's unfunded liability. No cost savings were estimated for this issue. However, the Commission maintained that allocating full civil service retirement costs to the agencies and recognizing the extent of the unfunded liability of the system could indirectly result in savings by focusing attention on the true cost of the pension plan.

We agree that the methods currently used to calculate and allocate civil service retirement costs to the agencies cause accruing costs to be understated. Accruing costs for funding purposes are determined on a "static" basis, using the assumptions that covered employees will receive no pay raises to increase their future retirement benefits and retirees' annuities will not be adjusted for inflation. Consequently, because of these unrealistic assumptions, the costs of government programs are understated, and an unfunded liability has been created in the retirement system. In the past, we have urged the Congress to require the adoption of actuarial valuation methods and funding provisions that reflect the full cost of accruing retirement benefits and to charge agency operations with costs not covered by employee contributions.

It must be recognized in evaluating this issue that an important difference exists between civil service and private sector pension funding practices. Contributions to private sector pension funds are usually made in cash or marketable securities by employers and/or employees. The cash contributions are invested in income-producing securities which are then sold in the securities markets when needed to make benefit payments. The essence of the private sector pension fund is that its receipts and investments represent cash or assets that can be converted to cash. On the other hand, the civil service retirement fund is required by law to be invested in federal securities. There is no cash involved in this kind of intragovernmental transaction, only

bookkeeping entries. When funds are needed to make benefit payments, the Treasury obtains the cash through its normal channels of tax receipts or borrowing from the public. The effect of fully funding civil service retirement costs, as they accrue, would be enhanced cost recognition.

We agree with the Commission that amortization of the unfunded liability would be consistent with the legal requirement that private sector pension plans amortize their unfunded liabilities. Also, the 1984 Defense Authorization Act required the military retirement system's unfunded liability to be amortized beginning in fiscal year 1985.

We also agree with the Commission that full funding of accruing retirement costs would not result in any direct savings to the retirement system. However, it would result in increased federal revenues through greater contributions from off-budget agencies (those whose operations are not funded by appropriated funds). Many such agencies have been established to operate on a self-supporting basis. To the extent that they would be required to contribute more to the retirement fund, federal revenues would increase. For example, the Postal Service could be required to increase its retirement contribution by over $3 billion a year if it were charged the full accruing retirement costs for its employees.

INVESTMENT POLICIES OF THE CIVIL SERVICE RETIREMENT SYSTEM ISSUE

As discussed above, the civil service retirement fund must, by law, be invested in federal securities. The Commission maintained that investments in corporate AAA bonds would provide a higher return with minimal risk and recommended that 25 percent of the fund's assets be invested in corporate AAA bonds. It estimated that additional revenues of $600 million over 3 years, on a present value basis, would accrue to the retirement fund if such action were taken.

Under current investment practices, marketable federal securities are seldom purchased. Rather, the civil service retirement fund is primarily invested in nonmarketable special issue securities. Interest on these securities is set at purchase on the basis of the average market yield on all marketable Treasury securities maturing or callable in more than 4 years.

The Treasury tries to minimize adverse effects on the financial markets by its borrowings. Thus, it adopted a policy of not using its good credit rating to earn higher interest on trust fund investments through arbitrage. In GAO's opinion, this is sound government policy.

The Commission said it did not have the time or resources to study the impact that a shift from federal securities to corporate securities would have on the financial markets. It recommended that the Department of Treasury and OPM consider the economic impact of the proposal on the financial markets before implementation. We agree that such an analysis would be appropriate.

In developing its savings estimate, the Commission assumed the historical 0.6 percentage point greater yield for corporate AAA bonds over Treasury bonds would continue. Whether this assumption is appropriate is unknown, particularly with the added purchases of corporate bonds the government would make if the recommendations were adopted. Moreover, the Commission assumed that the current retirement system and associated contribution levels would continue without change. This is not a valid assumption since the law already requires that a new retirement system be developed and in place by January 1, 1986, for those employees covered by social security. The content of the new system and the contribution amounts it will require are unknown at this time.

CHANGING THE CIVIL SERVICE RETIREMENT SYSTEM FROM A DEFINED BENEFIT TO A DEFINED CONTRIBUTION PLAN ISSUE

There are two types of pension plans--defined contribution and defined benefit. A defined contribution plan specifies the rate at which funds will be added to each participant's account. The benefits consist of the accumulated contributions and investment earnings (or losses) at the time of retirement. Defined benefit plans, on the other hand, use specified formulas which consider such factors as salary, age, and years of service to compute benefit amounts. The civil service retirement system is a defined benefit plan.

The Commission proposed that a defined contribution plan be established to replace the civil service retirement system, but it gave no details on how the new plan would be structured. Employer contribution rates were not shown; investment programs and tax treatment were not discussed; withdrawal eligibility, etc., were not mentioned. Therefore, we have no basis on which to evaluate the proposal other than to observe that the proposed approach would not be consistent with the manner in which retirement benefits are typically provided in the nonfederal sector.

Available data indicates that nearly all nonfederal employers with pension plans use the defined benefit approach. The Department of Labor's Bureau of Labor Statistics found in a 1982 survey of 976 pension plans covering 17 million employees that 99 percent of the employees were in defined benefit plans.

Similarly, a 1983 survey of 781 pension plans by the Hay Associates[6] found that 95 percent of the plans were of the defined benefit type. Furthermore, all states, with the exception of Nebraska, have defined benefit pension plans.

Many nonfederal employers also provide capital accumulation plans--that is, stock-ownership plans, profit-sharing plans, savings and investment plans, and deferred compensation plans--as supplements to their pension plans. Capital accumulation plans are defined contribution plans. The Bureau of Labor Statistics survey showed that 74 percent of the companies in the survey had capital accumulation plans for their employees.

State governments also often provide capital accumulation plans to supplement pension plan benefits. A 1982 survey by the Council of State Governments entitled State Deferred Compensation Programs showed that all but 3 of the 36 states surveyed had established or authorized deferred compensation plans for their employees in addition to their pension plans.

The Commission did not calculate a savings amount for this issue. Without information on how the proposed defined contribution pension plan would be structured, the cost of such a plan as compared to the civil service retirement system cannot be determined.

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[6]Hay Noncash Compensation Comparison, 1983.

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